SCS Agency
Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Lockyer	Analyst:	Jeff Garnier	Bill Number:	SB 519
Related Bills:		Telephone:	845-5322	Amended Date:	2-6-98
		Attorney:	Doug Bramhall	Sponsor:	

SUBJECT: Conformity to Certain Provisions of the Federal Taxpayer Relief Act of 1997 and 1997 Tax Law Clean-Up

_____ DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _________.

__X__ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

_____ AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended _________.

_____ FURTHER AMENDMENTS NECESSARY.

_____ DEPARTMENT POSITION CHANGED TO _______________________.

_____ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED/AMENDED ___________ STILL APPLIES.

__X__ OTHER - See comments below.

SUMMARY OF BILL

This bill would conform to several provisions of the federal Taxpayer Relief Act of 1997 and make technical clean-up corrections to various legislation passed in 1997. The changes purposed by this bill are:

DEPARTMENTS THAT MAY BE AFFECTED:

____ STATE MANDATE ____ GOVERNOR'S APPOINTMENT

Department Director Position:	Agency Secretary Position:	GOVERNOR'S OFFICE USE
____ S ____ O ____ SA ____ OUA ____ N ____ NP ____ NA ____ NAR ____X____ PENDING	____ S ____ O ____ SA ____ OUA ____ N ____ NP ____ NA ____ NAR DEFER TO ___________	Position Approved ____ Position Disapproved ____ Position Noted ____
Department/Legislative Director Date Gerald H. Goldberg 2/19/98	Agency Secretary Date	By: Date:

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SUMMARY OF AMENDMENT

Prior to the amendment this bill contained language affecting property tax law that did not affect the laws administered by the Franchise Tax Board (FTB). The amendment added the changes outlined above.

EFFECTIVE DATE

The effective dates are discussed in the each of the 13 items listed above.

SPECIFIC FINDINGS

1. Repeal Alternative Minimum Tax Installment Method Adjustment for Farmers.

The installment method allows gain on the sale of property to be recognized as payments are received. Under the regular tax, dealers in personal property are not allowed to defer the recognition of income by use of the installment method on the installment sale of such property. For this purpose, dealer dispositions do not include sales of any property used or produced in the trade or business of farming. For alternative minimum tax (AMT) purposes, the installment method is not available with respect to the disposition of any property that is the stock in trade of the taxpayer or any other property of a kind which would be properly included in the inventory of the taxpayer if held at year end, or property held by the taxpayer primarily for sale to customers.

Under **federal law,** prior to the enactment of the TRA of 1997, no explicit exception was provided for installment sales of farm property under AMT. The TRA of 1997 generally provided that for purposes of the AMT, farmers may use the installment method of accounting. Therefore, a farmer using the installment method will not have an adjustment for AMT purposes. The federal change generally is effective for dispositions in taxable years beginning after December 31, 1987, with a special rule for dispositions occurring in 1987.

California law is in conformity with federal law prior to the passage of the TRA. Therefore, California law generally does not allow the installment method for alternative minimum tax purposes.

This bill would conform California Law to federal law as it relates to the use of the installment method by farmers under AMT. Under California law, this bill would provide that payments received in taxable or income years beginning or after January 1, 1997 for installment sales made in taxable or income years beginning after December, 1987 would not have an AMT adjustment.

2. Termination of Suspense Accounts for Family Farming Corporations.

Under both federal and state law, a corporation (or a partnership with a corporate partner) engaged in the trade or business of farming must use an accrual method of accounting for such activities unless such corporation (or partnership), for each prior taxable year beginning after December 31, 1975, did not have gross receipts exceeding $1 million. If a farm corporation is required to change its method of accounting, the section 481 adjustment resulting from such change is included in gross income ratably over a 10-year period (a section 481 adjustment), beginning with the year of change. This rule does not apply to a family farm corporation.

A provision of the Revenue Act of 1987 (1987 Act) requires a family corporation (or a partnership with a family corporation as a partner) to use an accrual method of accounting for its farming business, unless for each prior taxable year beginning after December 31, 1985, such corporation (and any predecessor corporation) did not have gross receipts exceeding $25 million. A family corporation is one where at least 50% of the stock of the corporation is held by one, or in some limited cases, two or three, families.

A family farm corporation that must change to an accrual method of accounting as a result of the 1987 Act provision was **under prior federal law and current California law** required to establish a suspense account in lieu of including the entire amount of the section 481 adjustment in gross income. The initial balance of the suspense account equals the lesser of (1) the section 481 adjustment otherwise required for the year of change, or (2) the section 481 adjustment computed as if the change in method of accounting had occurred as of the beginning of the taxable year preceding the year of change. The amount of the suspense account was required to be included in gross income if the corporation ceased to be a family corporation. In addition, if the gross receipts of the corporation attributable to farming for any taxable year decline to an amount below the lesser of (1) the gross receipts attributable to farming for the last taxable year for which an accrual method of accounting was not required, or (2) the gross receipts attributable to farming for the most recent taxable year for which a portion of the suspense account was required to be included in income, a portion of the suspense account is required to be included in gross income.

Under federal law, the TRA of 1997 repealed the ability of a family farm corporation to establish a suspense account when it is required to change to an accrual method of accounting. Thus, under the TRA of 1997 , any family farm corporation required to change to an accrual method of accounting will restore the section 481 adjustment applicable to the change in gross income ratably over a 10-year period beginning with the year of change.

Additionally **under federal law**, any taxpayer with an existing suspense account is required to restore the account into income ratably over a 20-year period beginning in the first taxable year beginning after June 8, 1997, subject to the requirements (ceased to be a family corporation) to restore such accounts more rapidly. The TRA of 1997 repealed the requirement to accelerate the recovery of suspense accounts when the gross receipts of the taxpayer decreases.

The amount required to be restored to income for a taxable year pursuant to the 20-year spread period shall not exceed the net operating loss of the corporation for the year (in the case of a corporation with a net operating loss) or 50% of the net income of the taxpayer for the year (for corporations with taxable income). For this purpose, a net operating loss or taxable income is determined without regard to the amount restored to income under the provision. Any reduction in the amount required to be restored to income is taken into account ratably over the remaining years in the 20-year period or, if applicable, after the end of the 20-year period. Amounts that extend beyond the 20-year period remain subject to the net operating loss and 50%-of-taxable income rules. The net operating loss and 50%-of-taxable income rules do not apply to restorations of suspense accounts pursuant to present law.

Federal law also clarifies that in the case of a family farm corporation that elects to be an S corporation for a taxable year, the net operating loss and 50%

of taxable income limitations shall be determined by taking into account all the items of income, gain, deduction and loss of the corporation, regardless of whether such items are separately stated under section 1366.

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to family farm corporations being required to use the accrual method of accounting and suspense accounts.

This bill would conform California law to federal law as it relates to use of the accrual method of accounting and family farming corporations for income years beginning on or after January 1, 1998.

3. Survivor Benefits of Public Safety Officers Killed in the Line of Duty.

Under present federal and California law, survivors of military service personnel (such as those killed in combat) are generally entitled to survivor benefits These survivor benefits are generally exempt from taxation. “Survivor” means the surviving spouse or surviving dependent child of the military service personnel.

Under federal law, the TRA of 1997 generally provided that an amount paid as a survivor annuity on account of the death of a public safety officer who is killed in the line of duty is excludable from income to the extent the survivor annuity is attributable to the officer's service as a law enforcement officer. The survivor annuity must be provided under a governmental plan to the surviving spouse (or former spouse) of the public safety officer or to a child of the officer. Public safety officers include law enforcement officers, firefighters, rescue squad or ambulance crew. The exclusion does not apply with respect to the death of a public safety officer if it is determined by the appropriate supervising authority that (1) the death was caused by the intentional misconduct of the officer or by the officer's intention to bring about the death, (2) the officer was voluntarily intoxicated at the time of death, (3) the officer was performing his or her duties in a grossly negligent manner at the time of death, or (4) the actions of the individual to whom payment is to be made were a substantial contributing factor to the death of the officer. The exclusion applies to amounts received in taxable years beginning after December 31, 1996, with respect to individuals dying after that date.

California law is conformed to the federal provisions as of January 1, 1997, relating to survivor benefits and disability payments. Under California law, survivor annuity benefits paid under a governmental retirement plan to a survivor of a law enforcement officer killed in the line of duty are generally includible in income except to the extent the benefits are a return of after-tax employee contributions. Under present and prior law, survivor benefits paid under a government plan only to survivors of officers who died as a result of injuries sustained in the line of duty are in the nature of workers' compensation and are generally excludable from income.

This bill would conform California law to federal law as it relates to the taxability of survivor benefits of public safety officers with the same effective date.

4. Use of Certain Appraisals to Establish Amount of Disaster Loss.

Under existing federal law and state tax law, a taxpayer may claim a loss from a disaster in an area determined by the President of the United States to warrant federal assistance. The taxpayer may elect either to claim the disaster loss in the year the loss occurs or in the year preceding the loss. This election allows the taxpayer to immediately file an amended return for the prior year. For state purposes, this election may be made prior to passage of any state legislation allowing special carryback treatment because California conforms to the federal election.

As with casualty losses, nonbusiness disaster losses not reimbursed by insurance are deductible under state and federal tax law to the extent each loss exceeds $100, and total nonbusiness disaster losses are deductible only to the extent that the total loss amount for the year exceeds 10% of adjusted gross income.

To claim a disaster loss, a taxpayer must establish the amount of the loss. This may, for example, be done through the use of an appraisal.

Under federal law, the TRA of 1997 provides that nothing in the Internal Revenue Code should be construed to prohibit Treasury from issuing guidance providing that an appraisal for the purpose of obtaining a federal loan or federal loan guarantee as the result of a Presidentially-declared disaster may be used to establish the amount of a disaster loss. This federal provision applies August 5, 1997.

As stated above, **California law** is the same as federal. To claim a disaster loss, a taxpayer must establish the amount of the loss. This may be done through the use of an appraisal. There is no provision in California law that specifically addresses appraisals prepared for emergency federal disaster relief.

This bill would conform state law to federal law as it relates to the use of appraisals prepared for federal disaster relief for establishing the amount of a disaster loss with the same effective date.

5. Treatment of Livestock Sold on Account of Weather-Related Conditions.

Under federal and state law, in general, cash-method taxpayers report income in the year it actually is received or is constructively received. However, the law contains two special rules applicable to livestock sold because of drought conditions. A cash-method taxpayer whose principal trade or business is farming and who is forced to sell livestock due to drought conditions may elect to include income from the sale of the livestock in the taxable year following the taxable year of the sale. This elective deferral of income is available only if the taxpayer establishes that, under the taxpayer's usual business practices, the sale would not have occurred but for drought conditions that resulted in the area being designated as eligible for federal assistance. This exception is generally intended to put taxpayers that receive an unusually high amount of income in one year in the position they would have been in the absence of the drought. In addition, the sale of livestock (other than poultry) that is held for draft, breeding, or dairy purposes in excess of the number of livestock that would have been sold but for drought conditions is treated as an involuntary conversion under IRC section 1033(e). Consequently, gain from the sale of such livestock could be deferred by reinvesting the proceeds of the sale in similar property within a two-year period.

The federal law expanded, by the TRA of 1997, the special treatment for sale of livestock on account of drought to livestock sold on account of floods and other weather related conditions. The expansion of the treatment applies to sales and exchanges on or after January 1, 1997.

California law conforms to the prior federal law relating to the taxable year of inclusion for income from livestock sold because of drought conditions.

This bill would conform California law to federal law and expand the special treatment for sale of livestock on account of drought to livestock sold on account of floods and other weather-related conditions with the same effective date.

6. Abatement of Interest on Underpayments by Taxpayers in Presidentially-Declared Disaster Areas.

Under federal law, in the case of a Presidentially-declared disaster, the Secretary of the Treasury has the authority to postpone some tax-related deadlines, but has no authority to abate interest.

Under federal law, the TRA of 1997 requires the Secretary of the Treasury to abate interest for the same period of time for which the Secretary of the Treasury has provided an extension of time to file tax returns and pay taxes (and waives any penalty) for individuals located in Presidentially-declared disaster areas. The federal provision applies to disasters declared in 1997.

California law does not generally conform to the new federal abatement of interest provisions. Instead, California law provides that interest may be waived for any period for which the FTB determines that an individual or fiduciary demonstrates inability to pay that interest solely because of extreme financial hardship caused by significant disability or other catastrophic circumstance. The FTB may also extend the time for taxpayers taxed under the Personal Income Tax Law to pay the tax if good cause exists.

This bill would require the FTB to abate interest for individual taxpayers located in a Presidentially-declared disaster area for the period the FTB extended the time to file a return and pay the tax (and waive any penalty) with the same effective date.

7. Simplified Taxation of Earnings of Pre-Need Funeral Trusts.

A pre-need funeral trust is an arrangement where an individual purchases funeral services or merchandise from a funeral home for the benefit of a specified person in advance of that person's death. (The beneficiary may be either the purchaser or another person.) The purchaser enters into a contract with the provider of such services or merchandise whereby the purchaser selects the services or merchandise to be provided upon the death of the beneficiary, and agrees to pay for them in advance of the beneficiary's death. Such amounts (or a portion thereof) are held in trust during the beneficiary's lifetime and are paid to the seller upon the beneficiary's death.

Under federal law prior to the passage of the TRA of 1997 and current California law, pre-need funeral trusts generally were treated as grantor trusts, and the annual income earned by such trusts was taxed to the purchaser/grantor of the trust. Any amount received from the trust by the seller (as payment for services or merchandise) is includible in the gross income of the seller. To the extent that pre-need funeral trusts are treated as grantor trusts, numerous individual taxpayers were required to account for the earnings of such trusts on their tax returns, even though the earnings with respect to any one taxpayer may have been small.

Under federal law, the TRA of 1997 allows the trustee of a pre-need funeral trust to elect special tax treatment for such a trust, to the extent the trust would otherwise be treated as a grantor trust. A qualified funeral trust is defined as one which meets the following requirements: (1) the trust arises as the result of a contract with a person engaged in the trade or business of providing funeral or burial services or merchandise; (2) the only beneficiaries of the trust are individuals with respect to whom such services or merchandise are to be provided at their death; (3) the only contributions to the trust are contributions by or for the benefit of the trust beneficiaries; (4) the trust's only purpose is to hold and invest funds that will be used to make payments for funeral or burial services or merchandise for the trust beneficiaries; and (5) the trust has not accepted contributions totaling more than $7,000 by or for the benefit of any individual. For this purpose, “contributions” include all amounts transferred to the trust, regardless of how denominated in the contract. Contributions do not, however, include income or gain earned with respect to property in the trust. For purposes of applying the $7,000 limit, if a purchaser has more than one contract with a single trustee (or related trustees), all such trusts are treated as one trust. Similarly, if the Secretary of the Treasury determines that a purchaser has entered into separate contracts with unrelated trustees to avoid the $7,000 limit described above, the Secretary may require that such trusts be treated as one trust. For contracts entered into after 1998, the $7,000 limit is indexed annually for inflation.

Under federal law, the trustee's election to have this provision apply to a qualified funeral trust is to be made separately with respect to each purchaser's trust. It is anticipated that the Department of the Treasury will issue prompt guidance with respect to the simplified reporting requirements so that if the election is made, a single annual trust return may be filed by the trustee, separately listing the amount of income earned with respect to each purchaser. If the election is made, the trust is not treated as a grantor trust and the amount of tax paid with respect to each purchaser's trust is determined in accordance with the income tax rate schedule generally applicable to estates and trusts, but no deduction for a personal exemption is allowed. The tax on the annual earnings of the trust is payable by the trustee. The provision is effective for taxable years ending after August 5, 1997.

As under prior federal and current state law, amounts received from the trust by the seller are treated as payments for services and merchandise and are includible in the gross income of the seller. No gain or loss is recognized to the purchaser of the trust for payments from the trust to the purchaser upon cancellation of the contract, and the purchaser takes a carryover basis in any assets received from the trust upon cancellation.

California conforms to federal law as it relates to pre-need funeral trusts prior to the passage of the TRA of 1997.

This bill would conform California law to TRA of 1997 federal changes to pre-need funeral trusts with the same effective date.

8. Small Business Stock (Rollover of Gain)

The Revenue Reconciliation Act of 1993 provided individuals a 50% exclusion for the sale of certain small business stock acquired at original issuance and held for at least five years. One-half of the excluded gain is a minimum tax preference item. The amount of gain eligible for the 50% exclusion by an individual with respect to any corporation is the greater of (1) 10 times the taxpayer's basis in the stock or (2) $10 million. In order to qualify as a small business, when the stock is issued, the gross assets of the corporation may not exceed $50 million. The corporation also must meet an active trade or business requirement.

New federal law allows an individual to rollover gain from the sale or exchange of qualified small business stock held more than six months where the taxpayer uses the proceeds to purchase other qualified small business stock within 60 days of the sale. For purposes of the rollover provision, the replacement stock must meet the active business requirement for the six-month period following the purchase. Generally, the holding period of the replacement stock will include the holding period of the stock sold, except for purposes of determining whether the replacement stock was held for the required six-month holding period is met. The new law applies to sales after August 5, 1997.

California law conforms to the federal exclusion of 50% of the gain from the sale of small business stock with modifications. In addition to the federal requirements, for California purposes the corporation must be doing business in California throughout the five year period and 80% of its payroll must be attributable to employment located in California. California has not conformed to the rollover provision.

This bill would conform California law with the federal law small business stock rollover provisions only with respect to the rollover of qualified California small business stock using the same effective date.

9. Modifications of Rules for Real Estate Investment Trusts.

Under federal and state law, in general, real estate investment trust (REIT) is an entity that receives most of its income from passive real estate related investments and that receives conduit treatment for income tax purposes with respect to amounts that are distributed to shareholders. If an entity meets the qualifications for REIT status, the portion of its income that is distributed to the investors each year generally is taxed to the investors without being subjected to a tax at the REIT level; the REIT generally is subject to a corporate tax only on the income that it retains and on certain income from property that qualifies as foreclosure property.

Under federal law prior to the enactment of the TRA of 1997 and current California law the following applies:

Election to be treated as a REIT - To qualify as a REIT and thereby receive conduit treatment, an entity must elect REIT status. A newly-electing entity generally cannot have earnings and profits accumulated from any year in which the entity was in existence and not treated as a REIT. To satisfy this requirement, the entity must distribute, during its first REIT taxable year, any earnings and profits that were accumulated in non-REIT years. For this purpose, distributions by the entity generally are treated as being made from the most recently accumulated earnings and profits.

Taxation of REITS Overview - In general, if an entity qualifies as a REIT by satisfying the various requirements described below, the entity is taxable as a corporation on its “real estate investment trust taxable income” (REITTI) and also is taxable on certain other amounts. REITTI is the taxable income of the REIT with certain adjustments. The most significant adjustment is a deduction for dividends paid. The allowance of this deduction is the mechanism by which the REIT becomes a conduit for income tax purposes.

Capital Gains - A REIT that has a net capital gain for a taxable year generally is subject to tax on such capital gain under the capital gains tax regime generally applicable to corporations. However, a REIT may diminish or eliminate its tax liability attributable to such capital gain by paying a “capital gain dividend” to its shareholders. A capital gain dividend is any dividend or part of a dividend that is designated by the payor REIT as a capital gain dividend in a written notice mailed to shareholders. Shareholders who receive capital gain dividends treat the amount of such dividends as long-term capital gain regardless of the holding period of their stock.

A regulated investment company (RIC), but not a REIT, may elect to retain and pay income tax on net long-term capital gains it received during the tax year. If a RIC makes this election, the RIC shareholders must include in their income as long-term capital gains their proportionate share of these undistributed long-term capital gains as designated by the RIC. The shareholder is deemed to have paid the shareholder's share of the tax, which can be credited or refunded to the shareholder. Also, the basis of the shareholder's shares is increased by the amount of the undistributed long-term capital gains (less the amount of capital gains tax paid by the RIC) included in the shareholder's long-term capital gains.

Income from Foreclosure Property - In addition to tax on its REITTI, under federal law a REIT is subject to tax at the highest rate of tax paid by corporations on its net income from foreclosure property. California does not conform to this provision. Net income from foreclosure property is the excess of the sum of gains from foreclosure property that is held for sale to customers in the ordinary course of a trade or business and gross income from foreclosure property (other than income that otherwise would qualify under the 75% income test described below) over all allowable deductions directly connected with the production of such income.

Foreclosure property is any real property or personal property incident to such real property that is acquired by a REIT as a result of default or imminent default on a lease of such property or indebtedness secured by such property, provided that (unless acquired as foreclosure property) such property was not held by the REIT for sale to customers. A property generally may be treated as foreclosure property for a period of two years after the date the property is acquired by the REIT. The IRS may grant extensions of the period for treating the property as foreclosure property if the REIT establishes that an extension of the grace period is necessary for the orderly liquidation of the REIT's interest in the property. The grace period cannot be extended beyond six years from the date the property is acquired by the REIT.

Property will cease to be treated as foreclosure property if, after 90 days after the date of acquisition, the REIT operates the foreclosure property in a trade or business other than through an independent contractor from whom the REIT does not derive or receive any income.

Income or Loss from Prohibited Transactions - In general, a REIT must derive its income from passive sources and not engage in any active trade or business. Accordingly, in addition to the tax on its REITTI and for federal purposes, on its net income from foreclosure property, a 100% tax is imposed on the net income of a REIT from “prohibited transactions”. California does not conform to this 100% prohibited transaction tax provision. A prohibited transaction is the sale or other disposition of property described in section 1221(1) of the Internal Revenue Code (property held for sale in the ordinary course of a trade or business) other than foreclosure property. Thus, the 100% tax on prohibited transactions helps to ensure that the REIT is a passive entity and may not engage in ordinary retailing activities such as sales to customers of condominium units or subdivided lots in a development project. A safe harbor is provided for certain sales that otherwise might be considered prohibited transactions. The safe harbor is limited to seven or fewer sales a year or, alternatively, any number of sales provided that the aggregate adjusted basis of the property sold does not exceed 10% of the aggregate basis of all the REIT's assets at the beginning of the REIT's taxable year.

Requirements for REIT status - A REIT must satisfy four tests on a year-by-year basis: organizational structure, source of income, nature of assets, and distribution of income. These tests are intended to allow conduit treatment in circumstances in which a corporate tax otherwise would be imposed, only if there really is a pooling of investment arrangement that is evidenced by its organizational structure, if its investments are basically in real estate assets, and if its income is passive income from real estate investment, as contrasted with income from the operation of a business involving real estate. In addition, substantially all of the entity's income must be passed through to its shareholders on a current basis.

Organizational Structure - To qualify as a REIT, an entity must be for its entire taxable year a corporation or an unincorporated trust or association that would be taxable as a domestic corporation but for the REIT provisions, and must be managed by one or more trustees. The beneficial ownership of the entity must be evidenced by transferable shares or certificates of ownership. Except for the first taxable year for which an entity elects to be a REIT, the beneficial ownership of the entity must be held by 100 or more persons, and the entity may not be so closely held by individuals that it would be treated as a personal holding company if all its adjusted gross income constituted personal holding company income. A REIT is disqualified for any year in which it does not comply with regulations to ascertain the actual ownership of the REIT's outstanding shares. Treasury regulations require that the entity request information from certain shareholders regarding shares directly or indirectly owned by them.

Income Requirements Overview - In order for an entity to qualify as a REIT, at least 95% of its gross income generally must be derived from certain passive sources (the “95% test”). In addition, at least 75% of its income generally must be from certain real estate sources (the “75% test”), including rents from real property.

In addition, less than 30% of the entity's gross income may be derived from gain from the sale or other disposition of stock or securities held for less than one year, real property held less than four years (other than foreclosure property, or property subject to an involuntary conversion), and property that is sold or disposed of in a prohibited transaction.

Definition of Rents from Real Property - For purposes of the income requirements, rents from real property generally include: (1) rents from interests in real property; (2) charges for services customarily rendered or furnished in connection with the rental of real property, whether or not such charges are separately stated; and (3) rent attributable to personal property that is leased under or in connection with a lease of real property, but only if the rent attributable to such personal property does not exceed 15% of the total rent for the year under the lease.

Services provided to tenants are regarded as customary if, in the geographic market within which the building is located, tenants in buildings of a similar class (for example, luxury apartment buildings) are customarily provided with the service. The furnishing of water, heat, light, and air conditioning; the cleaning of windows, public entrances, exits, and lobbies; the performance of general maintenance and of janitorial and cleaning services; the collection of trash; the furnishing of elevator services, telephone answering services, incidental storage space, laundry equipment, watchman or guard service, parking facilities and swimming pool facilities are examples of services customarily furnished to tenants of a particular class of buildings in many geographical marketing areas.

Exclusion of Rents from Related Tenants - Amounts are not treated as qualified rent if they are received from corporate or noncorporate tenants in which the REIT, directly or indirectly, has an ownership interest of 10% or more.

Exclusion of Rents Where Services to Tenants Are Performed by Related Contractors - Where a REIT furnishes or renders services to the tenants, amounts received or accrued with respect to such property generally are not treated as qualifying rents unless the services are furnished through an independent contractor. A REIT may furnish or render a service directly, however, if the service would not generate unrelated business taxable income, if provided by certain state colleges and universities. In general, an independent contractor is a person: (1) who does not own more than a 35% interest in the REIT, (2) who is not owned 35% or greater by the REIT or, (3) who is not owned 35% or greater by persons who own 35% of the REIT.

Constructive Ownership Rules Involving Corporations - For purposes of determining the REIT's ownership interest in a tenant and whether a contractor is independent, certain attribution rules apply. If 10 or more percent of a REIT or other corporation is owned, directly or indirectly, by or for a person, that person is treated as owning that person's proportionate share of any stock owned directly or indirectly by that corporation.

Constructive Ownership Rules Involving Partnerships - Stock owned, directly or indirectly, by or for a partnership is considered owned proportionately by its partners. In addition, stock owned, directly or indirectly, by or for a partner is considered owned by the partnership. However, stock constructively owned by a partnership is not considered as owned for purposes of being constructively owned by partners.

Constructive Ownership of Contracts - If a person providing services to tenants of the REIT owns a greater-than-35% interest in the REIT, or if another person owns a greater-than-35% interest in both the REIT and a person providing services, amounts received or accrued by the REIT with respect to the property are not qualifying rents because the service provider does not qualify as an independent contractor.

Hedging Instruments - Interest rate swaps or cap agreements that protect a REIT from interest rate fluctuations on variable rate debt incurred to acquire or carry real property are treated as securities under the 30% test, and payments under these agreements are treated as qualifying under the 95% test.

Treatment of Shared Appreciation Mortgages - For purposes of the income requirements for qualification as a REIT, and for purposes of the prohibited transaction provisions, any income derived from a “shared appreciation provision” is treated as gain recognized on the sale of the “secured property.” For these purposes, a shared appreciation provision is any provision that is in connection with an obligation held by the REIT and secured by an interest in real property, which provision entitles the REIT to receive a specified portion of any gain realized on the sale or exchange of such real property (or of any gain that would be realized if the property were sold on a specified date). Secured property for these purposes means the real property that secures the obligation that has the shared appreciation provision.

In addition, for purposes of the income requirements for qualification as a REIT, and for purposes of the prohibited transaction provisions, the REIT is treated as holding the secured property for the period during which it held the shared appreciation provision (or, if shorter, the period during which the secured property was held by the person holding such property), and the secured property is treated as inventory property held for sale if it is such property in the hands of the obligor on the obligation to which the shared appreciation provision relates (or if it would be such property if held by the REIT).

For purposes of the prohibited transaction safe harbor, the REIT is treated as having sold the secured property at the time that it recognizes income on account of the shared appreciation provision, and any expenditures made by the holder of the secured property are treated as made by the REIT.

Asset Requirements - To satisfy the asset requirements to qualify for treatment as a REIT, at the close of each quarter of its taxable year, an entity must have at least 75% of the value of its assets invested in real estate assets, cash and cash items, and government securities. Moreover, not more than 25% of the value of the entity's assets can be invested in securities of any one issuer (other than government securities and other securities described in the preceding sentence). Further, these securities may not comprise more than 5% of the entity's assets or more than 10% of the outstanding voting securities of such issuer. The term real estate assets is defined to mean real property (including interests in real property and mortgages on real property) and interests in REITs.

REIT Subsidiaries - All the assets, liabilities, and items of income, deduction, and credit of a “qualified REIT subsidiary” are treated as the assets, liabilities, and respective items of the REIT that owns the stock of the qualified REIT subsidiary. A subsidiary of a REIT is a qualified REIT subsidiary if and only if 100% of the subsidiary's stock is owned by the REIT at all times that the subsidiary is in existence. If at any time the REIT ceases to own 100% of the stock of the subsidiary, or if the REIT ceases to qualify for (or revokes an election of) REIT status, such subsidiary is treated as a new corporation that acquired all of its assets in exchange for its stock (and assumption of liabilities) immediately before the time that the REIT ceased to own 100% of the subsidiary's stock, or ceased to be a REIT as the case may be.

Distribution Requirements - To satisfy the distribution requirement, a REIT must distribute as dividends to its shareholders during the taxable year an amount equal to or exceeding (i) the sum of 95% of its REITTI other than net capital gain income and 95% of the excess of its net income from foreclosure property over the tax imposed on that income minus (ii) certain excess noncash income. Excess noncash items include (1) the excess of the amounts that the REIT is required to include in income with respect to certain rental agreements involving deferred rents, over the amounts that the REIT otherwise would recognize under its regular method of accounting, (2) in the case of a REIT using the cash method of accounting, the excess of the amount of original issue discount and coupon interest that the REIT is required to take into account with respect to certain loans which the issue price is determined under the Internal Revenue Code’s sale leaseback provisions, over the amount of money and fair market value of other property received with respect to the loan, and (3) income arising from the disposition of a real estate asset in certain transactions that failed to qualify as like-kind exchanges under section 1031.

The TRA of 1997 made modifications to federal law relating to the general requirements for qualification as a REIT, the taxation of a REIT, the income requirements for qualification as a REIT, and certain other provisions. The changes are effective for taxable years beginning after August 5, 1997.

Clarification of Limitation on Maximum Number of Shareholders and Penalties for Failure to Determine Ownership - The TRA of 1997 replaces the rule that disqualifies a REIT for any year in which the REIT failed to comply with Treasury regulations to ascertain its ownership with an intermediate penalty for failing to do so. The penalty is $25,000 ($50,000 for intentional violations) for any year in which the REIT did not comply with the ownership regulations. The REIT also is required, when requested by the IRS, to send curative demand letters.

In addition, a REIT that complied with the Treasury regulations for ascertaining its ownership, and which did not know, or have reason to know, that it was so closely held as to be classified as a personal holding company, is treated as meeting the requirement that it not be a personal holding company.

De Minimis Rule for Tenant Services Income - The TRA of 1997 permits a REIT to render a de minimis amount of impermissible services to tenants, or in connection with the management of property, and still treat amounts received with respect to that property as rent. The value of the impermissible services may not exceed 1%

of the gross income from the property. For these purposes, the services may not be valued at less than 150% of the REIT's direct cost of the services.

25% Attribution for Partners - The TRA of 1997 modified the application of the rule attributing ownership from partners to partnerships for purposes of defining non-qualifying rent from related persons, so that attribution occurs only when a partner owns, directly or indirectly, a 25% or greater interest in the partnership. Thus, a REIT and a tenant will not be treated as related (and, therefore, rents paid by the tenant to the REIT will not be treated as non-qualifying rents) if the REIT's shares are owned by a partnership and a partner owning, directly or indirectly, a less-than-25% interest in that partnership also owns an interest in the tenant. The related tenant rule also will not be violated where owners of the REIT and owners of the tenant are partners in a partnership and either the owners of the REIT or the owners of the tenant are, directly or indirectly, less-than-25% partners in the partnership.

In addition, the TRA of 1997 extends, to the definition of an independent contractor, the modification to the attribution to partnerships so that attribution occurs only when a partner owns a 25% or greater interest in the partnership. Thus, a person providing services will not fail to be an independent contractor (and, therefore, amounts received or accrued by the REIT with respect to the property will not be treated as non-qualifying rents) where the REIT's shares are owned by a partnership and a partner owning, directly or indirectly, a less-than-25% interest in the partnership also owns an interest in a contractor. Similarly, a contractor will not fail to be an independent contractor where owners of the REIT and owners of the contractor are partners in a partnership and either the owners of the REIT or owners of the tenant are, directly or indirectly, less-than-25% partners in the partnership.

Credit Retained Capital Gains Tax Paid - The TRA of 1997 permits a REIT to elect to retain and pay income tax on net long-term capital gains it received during the tax year, just as a RIC is permitted to do. Thus, if a REIT made this election, the REIT shareholders would include in their income as long-term capital gains their proportionate share of the undistributed long-term capital gains as designated by the REIT. The shareholder would also be deemed to have paid the shareholder's share of the tax paid by the REIT, which would be credited or refunded to the shareholder. Also, the basis of the shareholder's shares would be increased by the amount of the undistributed long-term capital gains (less the amount of capital gains tax paid by the REIT) included in the shareholder's long-term capital gains.

30% Gross Test Repealed - The TRA of 1997 repealed the rule that requires less than 30% of a REIT's gross income be derived from gain from the sale or other disposition of stock or securities held for less than one year, certain real property held less than four years, and property that is sold or disposed of in a prohibited transaction.

Ordering Rules for Earnings and Profits Distribution - The TRA of 1997 changes the ordering rule for purposes of the requirement that newly-electing REITs distribute earnings and profits that were accumulated in non-REIT years. Distributions of accumulated earnings and profits generally are treated as made from the entity's earliest accumulated earnings and profits, rather than the most recently accumulated earnings and profits. These distributions are not treated as distributions for purposes of calculating the dividends paid deduction.

Grace Period for Foreclosure Property Extended - The TRA of 1997 lengthened the original grace period for foreclosure property until the last day of the third full taxable year following the election. The grace period also could be extended for an additional three years by filing a request with the IRS. A REIT could revoke an election to treat property as foreclosure property for any taxable year by filing a revocation on or before the due date for filing its tax return.

In addition, the TRA of 1997 conformed the definition of independent contractor for purposes of the foreclosure property rule to the definition of independent contractor for purposes of the general rules.

Payments for Hedging Treated as Qualifying Income - The TRA of 1997 treats income from all hedges that reduce the interest rate risk of REIT liabilities, not just from interest rate swaps and caps, as qualifying income under the 95% test. Thus, payments to a REIT under an interest rate swap, cap agreement, option, futures contract, forward rate agreement or any similar financial instrument entered into by the REIT to hedge its indebtedness incurred or to be incurred (and any gain from the sale or other disposition of these instruments) are treated as qualifying income for purposes of the 95% test.

Definition of Excess Noncash Income Expanded - The TRA of 1997: (1) expanded the class of excess noncash items that are not subject to the distribution requirement to include income from the cancellation of indebtedness and (2) extended the treatment of original issue discount and coupon interest as excess noncash items to REITs that use an accrual method of taxation.

Involuntary Conversions Ignored for Prohibited Sales - The TRA of 1997 excludes from the prohibited sales rules property that was involuntarily converted.

Shared Appreciation Clarified, Bankruptcy Safe Harbor Added - The TRA of 1997 provides that interest received on a shared appreciation mortgage is not subject to the tax on prohibited transactions where the property subject to the mortgage is sold within four years of the REIT's acquisition of the mortgage pursuant to a bankruptcy plan of the mortgagor unless, when the REIT acquired the mortgage, and the REIT knew, or had reason to know, that the property subject to the mortgage would be sold in a bankruptcy proceeding.

Qualified REIT Subsidiary Definition Modified - The TRA of 1997 permits any corporation wholly-owned by a REIT to be treated as a qualified subsidiary, regardless of whether the corporation had always been owned by the REIT. Where the REIT acquired an existing corporation, any such corporation is treated as being liquidated as of the time of acquisition by the REIT and then reincorporated (thus, any of the subsidiary's pre-REIT built-in gain would be subject to tax under the normal rules). In addition, any pre-REIT earnings and profits of the subsidiary must be distributed before the end of the REIT's taxable year.

California law conforms to the federal treatment of REITs prior to the passage of the TRA with the following modifications:

- REIT taxable income does
  - not include a deduction for dividends received from certain corporations,
  - not include a deduction for the tax imposed for not meeting the 95% or 75% income test,
  - include income from foreclosure property,
  - include income from prohibited transactions,
  - include net capital gain income.

- Taxes on “income from foreclosed property, “income of a prohibitive transaction”, “alternative tax on capital gains” and failure to meet the 95% or 75% income test do not apply.

- A REIT is subject to the corporate minimum tax (currently $800).

This bill would conform California to changes made to federal law by the TRA of 1997 as they affect REITs with same effective dates.

10. Repeal of 30% Gross Income Test for Regulated Investment Companies.

To qualify as a regulated investment company (RIC), a company must derive less than 30% of its gross income from the sale or other disposition of certain investments (including stock, securities, options and forward contracts) held for less than three months (the “30% test” or “short-short rule”).

Under federal law the TRA of 1997 repealed the 30% test (or short-short rule). The provision is repealed effective for taxable years beginning after August 5, 1997.

California law conforms to the federal treatment of RICs with certain modifications. The 30% test or “short-short rule” applies to California law.

This bill would repeal the 30% test for California purposes with the same effective date as federal.

11. Qualified Subchapter S Subsidiary Tax Subject to Estimated Tax Payments.

Under federal and state law, effective for income years beginning on or after January 1, 1997, S corporations are allowed to own subsidiaries. The S corporation cannot file a consolidated return for federal purposes or a combined report for state purposes with its subsidiary. However, if the S corporation owns 100% of the subsidiary, the S corporation may elect to treat the subsidiary as a “qualified subchapter S subsidiary” (QSSS). A QSSS is not treated as a separate corporation for tax purposes and all the assets, liabilities and items of income, deduction and credit treated as the assets, liabilities and items of income, deduction and credit of the (parent) S corporation.

Under California law, a QSSS is subject to a $800 tax assessed annually. The annual tax is assessed on the QSSS but is also the liability of the S corporation. The annual tax is due and payable on the 15^{th} day of the fourth month of the S corporation’s income year, the same day the S corporation’s first estimated tax payment installment is due. The QSSS annual tax is subject to the failure to pay tax (by due date) penalty and interest. However, the QSSS is not required to file a return. Consequentially, the FTB would be unable to determine if an S corporation should have paid the QSSS annual tax on the 15th day of the fourth month of its income year until the S corporation filed its tax return (possibly as late as 18 months later).

Additionally, present **California law** does not address the possibility of a S corporation acquiring an QSSS after the 15th day of the fourth month of the S corporation’s income year.

This bill would modify the QSSS tax to make it due and payable (and subject to the same kinds of penalties) as the minimum tax of the S corporation, with modifications to reflect that there could be more than one QSSS tax owed by a single S corporation owner and that the election for QSSS treatment can occur at any time during the year. Basically, this bill would make the QSSS tax due when the S corporation’s tax return is due, but the tax would be subject to the estimated tax rules and would be payable when the first estimated tax payment of the S corporation is due. If the QSSS was acquired during the income year, the QSSS tax would be due with the first estimated tax payment of the S corporation after the date of the QSSS election. Under this scenario, a S corporation paying the QSSS tax with the return would only be subject to the estimated tax penalty (which is computed like interest) and not the failure to pay tax (by the due date) penalty and interest.

12. <u>1997 Clean Up Provisions.</u>

This bill would make numerous technical, clarifying and clean-up changes needed as a result of legislation enacted during 1997.

a. Reinstate portions of AB 1217 (Stats. 1997, Ch. 602) that were chaptered out by SB 1106 (Stats. 1997, Ch. 604) and SB 1234 (Stats. 1997, Ch. 608). The amendments to Sections 17039 and 23036 would reinstate targeted tax area credits to the list of credits that can reduce regular tax below tentative minimum tax for taxable or income years beginning on or after January 1, 1998. The amendments to Sections 17276.2 and 24416.2 would reinstate the targeted tax area net operating loss provisions for taxable or income years beginning on or after January 1, 1998.

b. Reinstate changes made by SB 1106 and SB 455 that were chaptered out by SB 1233 (Stats. 1997, Ch. 612).

   The amendment to add subparagraphs (B), (C) and (D) of paragraph (4) of Section 17062 would reinstate the definitions of “aggregate gross receipts, less returns and allowances,” “gross receipts less returns and allowances” and “proportionate interest.” These items were enacted for 1997 by SB 1106 and SB 455 to clarify the definition of “qualified taxpayer” that was enacted by SB 38 (Stats. 1996, Ch. 954). SB 1233 “chaptered out” the definitions beginning in 1998. Therefore this bill would reinstate the definitions for taxable and income years beginning on or after January 1, 1998.

   The amendment to add paragraph (3) of subdivision (c) of Section 17062 would reinstate the adjustment item for the difference between the stock’s fair market value when it was purchased and the option price for California Qualified Stock Options. This provision was originally enacted by AB 3194 (Stats. 1996, Ch. 951) but was “chaptered out” by

SB 38. SB 1106 and SB 455 re-enacted the provisions for 1997, but SB 1233 chaptered it out for 1998.

c. Repeal duplicate sections enacted by both SB 5 (Stats. 1997, Ch. 610), in stand-alone language, and SB 455, in date change language. This bill would repeal Sections 17731.5, 19365, 23800.5, 23813 and 24954 that were enacted by SB 5.

d. Reinstate a provision of SB 5 chaptered out by SB 1233. This bill would amend Section 18510 to reinstate the filing requirement for taxpayers whose only income is from the excludible gain on the sale of a personal residence for 1997. This requirement is in the law for 1998.

e. Reinstate a provision of SB 455 chaptered out by SB 1233. This bill would amend Section 19184 to reinstate the penalty for failure to file medical savings account (MSA) reports for 1997. This penalty is in the law for 1998.

f. Removes an AMT exemption for merchant marine capital construction accounts inadvertently not removed by SB 455, which conformed California law to the federal treatment of merchant marine capital construction accounts.

g. Correct errors in Section 17062 relating to married filing separate exemption and phase-out amounts in the alternative minimum tax (AMT) provisions. SB 1233 added these amounts to Section 17062. SB 1233 used the amounts published in the department’s Alternative Minimum Tax Report. However, the Alternative Minimum Tax Report contained typographical errors. The married filing separate exemption amount should be $28,630 and the phase-out amount should be $107,362 instead of $28,360 and $117,362, respectively. Married filing separate amounts are normally one-half of married filing joint amounts.

h. Correct an incorrect reference in Section 19280. The reference to Section 18401 should be a reference to Section 17001.

i. Delete an obsolete reference to Section 23184 from Section 23802. AB 1040 (Stats. 1997, Ch. 605) repealed Section 23184 since it was obsolete.

j. Correct an incorrect reference in Section 24918. The reference to Section 13226 of Public Law 103-66 should be a reference to Section 13150 of that public law.

k. Clarify that for purposes of the definition of “qualifying dividends” in Section 24411, the term “corporation” would include banks only for income years beginning on or after January 1, 1998. This resolves the discrepancy between Act Sections 110 and 112 of AB 1040. Act Section 110 provided that the amendments made to Section 24411 by AB 1040 applied from the original effective date of the act adding Section 24411 to the Revenue and Taxation Code. However, Action Section 112 provided that the amendments to Section 24411 would apply to income years beginning on or after January 1, 1998.

l. Clarify that the duplicate zone sections repealed by SB 200 were repealed on January 1, 1997. SB 965 and SB 200 both repealed duplicate zone sections. SB 965 repealed the sections as of January 1, 1997, the date they were originally enacted. SB 200, which was enacted last, did not specify a repeal date and thus the repeal became operative on January 1, 1998 (the operative date of SB 965).

m. Clarify that SB 455 repealed the Section 17267 relating to Medical Savings Accounts (MSAs). There were two Sections 17267 enacted during 1996; one relating to zones (AB 296, Stats. 1996, Ch. 953) and the other relating to MSAs (SB 38, Stats. 1996, Ch. 954). SB 965 repealed the version enacted by AB 296, relating to zones (the act specifies as enacted by AB 296). SB 455 did not specify that it was repealing Section 17267 as enacted by SB 38; however, SB 455 as amended May 1, 1997, struck out the text of Section 17267 relating to MSAs.

13. Waiver of estimated tax penalty.

This bill would waive additions to tax imposed for any underpayments of tax or estimated tax for any period before April 15, 1998, with respect to any underpayment for the 1997 or 1998 taxable or income year to the extent the underpayment was created or increased by any provision of this bill.

Implementation Considerations

Implementing this bill would not significantly impact the department's programs and operation.

Technical Considerations

The bill contains several technical issues that involve writing styles and operative dates. The author's office has been advised of the issues and are preparing amendments.

FISCAL IMPACT

Departmental Costs

The provisions of this bill would not significantly impact the department's costs.

Tax Revenue Estimate

The impact from the provisions of this bill is estimated as follows:

Effective Income/Taxable Years After January 1, 1998 Assumed Enactment After June 30, 1998						
	Personal Income Tax (in millions)			Bank & Corporation Tax (in millions)		
Provision	1998-9	1999-0	2000-1	1998-9	1999-0	2000-1
AMT & Farm. Install.Sales	($1)	($1)	($1)	($1)	($1)	($1)
Fam. Farm Suspense Accts	---	---	---	$1	$1	$1
Pub.Officers Surv.Ben.	a/	a/	a/	---	---	---
Disaster Losses	a/	a/	a/	a/	a/	a/
Livestock due to Weather	a/	a/	a/	a/	a/	a/
Abate Int.-Disaster Areas	a/	a/	a/	a/	a/	a/
Funeral Trusts	b/	b/	b/	---	---	---
Sm.Bus.Stock(Rollover)	($2)	($4)	($5)	---	---	---
Modify Rules for REITS	---	---	---	c/	c/	c/
Repeal 30% Inc. Test	d/	d/	d/	d/	d/	d/
Totals	($3)	($5)	($6)	$0	$0	$0

a/ Negligible loss less than $250,000

b/ Negligible gain less than $250,000

c/ Minor loss less than $500,000

d/ Unknown minor net gain or loss depending on relative tax rates of entity vs. shareholders.

The 1997 clean-up provisions outlined in item 12 above have no revenue impact. The provisions are either technical in nature or have been accounted for in a analysis of an enacted bill.

Revenue impacts above were based on federal projections for these provisions in H.R. 2014 in conjunction with available state data.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

BOARD POSITION

Pending.